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THE JAPANESE DISTRIBUTION SYSTEM

Summary

The perception that the prices of imports in Japan have failed to fully reflect the sharp appreciation of the yen during the past two years has focused attention on the country's distribution system. Although a January 1987 government survey of 30 imported products did find significant cuts in the prices of 14 items and marginal declines in 15 others, import prices still seem unreasonably high and wholesalers are said to be enjoying windfall profits. Foreign businesses have complained that Japan's market opening efforts will be ineffectual if the sale of foreign goods is effectively limited by the distribution system.

Analysts have criticized Japan's distribution system as archaic and excessively cumbersome. It should be noted, though, that the system developed as a rational response to economic conditions in Japan and that it is in the midst of a vast restructuring, reflecting changing conditions. There are several policies that Tokyo could adopt to encourage these changes and promote imports, such as restricting anti-competitive practices and relaxing the restrictions on large retail stores, which sell a greater share of imports than small stores. Moreover, the government can encourage parallel imports, which are sold at prices significantly below foreign goods imported through regular channels.

The Ultimate Barrier to Imports?

Japan has made significant progress in reducing import barriers in response to foreign criticism of its trading system and large trade surpluses.

Eight market opening packages have been announced since December 1981 and there are now fewer overt trade restrictions on manufactured goods than in most other developed countries. The average tariff rate is among the lowest of advanced industrial countries at 2.6 percent, compared to 2.7 percent in the European Community and 3.6 percent in the United States. Japan imposes import quotas on only five mined and manufactured products, compared to six in the United States, eight in Italy and 46 in France.

Because of this, attention has shifted to less obvious barriers, such as regulatory restrictions, technical standards, cumbersome customs procedures and government procurement policies. In July 1985 the "Action Program For Improved Market Access" was initiated to respond to these complaints. A study prepared last year for the American Chamber of Commerce in Japan concluded that "While there is still room for further improvements in some areas, overall, the Japanese government is making an effort to remove obstacles and increase transparency." Several studies have concluded that the effect of Japan's tariff and nontariff barriers is surprisingly small. According to a 1984 report by the Institute for International Economics, the complete elimination of all import restrictions would have only increased U.S. exports to Japan by $5 billion to $8 billion in 1984, only a small fraction of the $36.8 billion trade imbalance that year. U.S. trade restrictions, it was noted, reduced Japanese imports to this country by a similar amount.

Increasingly, Japan's complex distribution system has been cited as the primary factor limiting imports. According to a 1982 report by the U.S. Trade Representative's Office, Japan's vast distribution network has "more wholesalers and retailers per capita than any other of the advanced industrial nations." The complexity of the system is a result of many layers of wholesalers selling largely to each other and innumerable, tiny retail outlets. Many foreign business executives complain that the system makes it difficult for their products to reach Japanese consumers at reasonable prices.

Development and Characteristics of Japan's Distribution System

Although it has only half the population of the United States, Japan had more wholesale establishments in 1982 (see Table 1) and just 10 percent fewer retail stores (see Table 2). Japanese retail establishments tend to be relatively small, averaging only half as many employees as in the United States. According to a 1984 report by the Economic Planning Agency, labor productivity in the wholesale and retail trade in Japan is 31 percent below the United States'. Japan's distribution system is seemingly out of step with the changes that have occurred elsewhere in the economy.

There are sound economic reasons, however, for most of these structural differences. One important feature has been the consumer's lack of mobility, encouraging purchases close to home. In 1960, for example, there was only one car for every 32 people. The increase in that ratio to one per 2.6 persons in 1985 has promoted the development of larger retail stores. In urban areas, though, inadequate parking and crowded roads still encourage shopping at small neighborhood shops. A second notable characteristic is the Japanese consumer's

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preference for fresh fish and vegetables, which leads to daily shopping trips to nearby stores. These factors have resulted in the development of a network of small retail stores to meet the needs of consumers and, in turn, several layers of wholesalers to supply the retailers.

Table 1: Comparison of the Wholesale Industry in Japan and the United States, 1982

	Japan	United States
Number of wholesale establishments (thousands)	429.0	416.0
Number of employees (thousands)	4,091.0	4,985.0
Number of employees per wholesaler	9.5	12.0
Population per employee in wholesale industry	29.0	46.5
Total annual sales (in billions of dollars*)	$1,600.0	$1,998.0
Annual sales per wholesaler (in millions of dollars*)	$3.7	$4.8
Annual sales per employee (in thousands of dollars*)	$391.1	$400.8
Ratio of wholesale sales to retail sales	4.2	1.9

*Converted to dollars at 1982's average exchange rate of Y249.08=$1.00.

Source: U.S. Department of Commerce, Statistical Abstract of the United States, 1986; Japan's Management and Coordination Agency, Japan Statistical Yearbook, 1986.

Table 2: Comparison of the Retail Industry in Japan and the United States, 1982

	Japan	United States
Number of retail establishments (thousands)	1,721.0	1,923.0
Number of employees (thousands)	6,369.0	14,468.0
Number of employees per retailer	3.7	7.5
Population per employee in retail industry	18.6	16.0
Total annual sales (in billions of dollars*)	$377.3	$1,065.9
Annual sales per retailers (in thousands of dollars*)	$219.2	$554.3
Annual sales per employee (in thousands of dollars*)	$59.2	73.7
Ratio of retailers to wholesalers	4.0	4.6

*Converted to dollars at 1982's average exchange rate of Y249.08=$1.00.

Source: U.S. Department of Commerce, Statistical Abstract of the United States, 1986; Japan's Management and Coordination Agency, Japan Statistical Yearbook, 1986.

Table 3: Size Structure of Wholesalers

Number of Employees	1964 Establishments Number	1964 Establishments Share	1964 Sales (Y billion)	1964 Sales Share	1982 Establishments Number	1982 Establishments Share	1982 Sales (Y billion)	1982 Sales Share	Percentage Point Change in Share, 1964-82: Number of Establishments	Percentage Point Change in Share, 1964-82: Sales
1- 2	56,739	24.8%	Y413	1.1%	100,000	23.3%	Y5,081	1.3%	-1.5	+0.2
3- 4	49,157	21.4	1,172	3.0	108,000	25.1	16,039	4.0	+3.7	+1.0
5- 9	62,427	27.2	3,504	9.0	120,000	27.9	42,487	10.7	+0.7	+1.7
10-19	35,836	15.6	5,115	13.2	61,000	14.2	51,297	12.9	-1.4	-0.3
20-29	10,823	4.7	3,136	8.1	18,000	4.2	32,244	8.1	-0.5	0.0
30-49	7,521	3.3	3,958	10.2	13,000	3.0	38,325	9.6	-0.3	-0.6
50-99	4,424	1.9	4,690	12.1	7,000	1.6	47,942	12.0	-0.3	-0.1
100+	2,321	1.0	16,843	43.4	2,800	0.7	165,121	41.4	-0.3	-2.0
Total	229,248	100.0	38,381	100.0	429,800	100.0	398,536	100.0	0.0	0.0

Source: Calculated from data in Japan Statistical Yearbook.

Japan's distribution system is characterized by long-term commitments intended to insure a secure and steady supply of goods from manufacturers to consumers. Geographic factors, including narrow streets and space constraints that limit inventories, force frequent, small-lot deliveries. In addition, there is considerable risk-sharing among the various players. Retailers, for example, generally have the right to return unsold goods.

Wholesalers, a category that includes the big trading companies such as Mitsubishi Corp. and Mitsui & Co., Ltd., have played a major role in Japan's economy. Most goods pass through more than one wholesaler on their way from the factory to the consumer. Wholesale sales were 4.2 times greater than retail sales in Japan in 1982, compared to 1.9 times in the United States. In many industries they have been a vital link between small manufacturers and retailers, providing financing, transport, storage and managerial and marketing skills. Many family-owned stores, lacking the resources to expand, have relied on their wholesalers to provide long-term financing. Given the lack of storage space in many retail establishments, wholesalers have also been required to provide frequent deliveries.

Large wholesalers continue to dominate the industry. Although only 2.3 percent of wholesale establishments had more than 50 employees in 1982, they accounted for over half of the sales in the industry (see Table 3). Small firms, though, still play a significant role. Firms with fewer than 10 employees, which nearly doubled in number between 1964 and 1982, increased their market share by almost 3 percentage points. And surprisingly, the trend is toward smaller firms; the average number of employees per wholesale establishment has fallen from its peak of 11.6 in 1972 to 9.7 in 1985 (see Table 4).

Table 4: Trends in the Japanese Wholesale Industry, 1954-85

Year	Total Number of Establishments (thousands)	Employees (thousands)	Employees per Establishment	Annual Sales (Y billion)	Sales per Employee (Y million)
1954	174	1,130	6.5	Y9,015	Y7.98
1956	180	1,294	7.2	11,840	9.15
1958	193	1,551	8.1	13,986	9.02
1960	226	1,928	8.5	18,468	9.58
1962	223	2,129	9.5	27,474	12.91
1964	229	2,524	11.0	38,830	15.39
1966	287	3,042	10.6	52,082	17.12
1968	240	2,697	11.3	62,817	23.29
1970	256	2,861	11.2	88,331	30.88
1972	259	3,008	11.6	106,780	35.50
1974	292	3,290	11.3	173,113	52.62
1976	340	3,513	10.3	222,315	63.28
1979	369	3,673	10.0	274,545	74.75
1982	429	4,091	9.5	398,536	97.42
1985	413	3,997	9.7	426,506	106.71

Source: Japan's Management and Coordination Agency, Japan Statistical Yearbook, 1986.

Table 5: Size Structure of Retailing

Number of Employees	1964 Stores Number	1964 Stores Share	1964 Sales (Y billion)	1964 Sales Share	1982 Stores Number	1982 Stores Share	1982 Sales (Y billion)	1982 Sales Share	Percentage Point Change in Share, 1964-82: Number of Stores	Percentage Point Change in Share, 1964-82: Sales
1- 2	916,835	70.3%	Y1,816	21.7%	1,036,000	60.2%	Y13,183	14.0%	-10.1	-7.7
3- 4	250,897	19.2	1,730	20.7	413,000	24.0	17,721	18.9	+4.8	-1.8
5- 9	98,240	7.5	1,699	20.3	188,000	10.9	20,627	22.0	+3.4	+1.7
10-19	26,318	2.0	960	11.5	54,000	3.1	11,791	12.5	+1.1	+1.0
20-29	6,221	0.5	372	4.5	15,000	0.9	5,739	6.1	+0.4	+1.6
30-49	3,730	0.3	350	4.2	9,500	0.6	6,059	6.4	+0.3	+2.2
50-99	1,609	0.1	311	3.7	4,500	0.3	5,393	5.7	+0.2	+2.0
100+	686	0.1	1,112	13.3	1,900	0.1	13,457	14.3	0.0	+1.0
Total	1,304,536	100.0	8,350	100.0	1,721,900	100.0	93,970	100.0	0.0	0.0

Source: Calculated from data in Japan Statistical Yearbook.

Unlike wholesaling, the retail industry is dominated by small establishments. Retail outlets with fewer than 10 employees accounted for 54.9 percent of sales in 1982 (see Table 5). Large stores, however, are much more efficient than small stores in Japan; although less than 1 percent of retail establishments had more than 30 employees in 1982, they accounted for about one-fourth of total retail sales in Japan. In contrast to the trend in wholesaling, large stores are gaining a greater share of the market and the average number of employees has increased significantly in the past 20 years (see Table 6). Many of the major retailers are supermarkets, which have increased market share at the expense of department stores (see Table 7). Still, only two of the top 20 retailers in Japan are large enough to be included in a list of the top 20 in the United States.

Table 6: Trends in the Japanese Retail Industry, 1954-85

Year	Total Number of Stores (thousands)	Employees (thousands)	Employees per store	Annual Sales (Y billion)	Sales per Employee (Y million)
1954	1,189	2,717	2.3	Y2,592	Y0.95
1956	1,201	3,005	2.5	2,999	1.00
1958	1,245	3,273	2.6	3,549	1.08
1960	1,288	3,489	2.7	4,315	1.24
1962	1,272	3,550	2.8	6,149	1.73
1964	1,305	3,811	2.9	8,350	2.45
1966	1,375	4,193	3.0	10,684	2.55
1968	1,432	4,646	3.2	16,507	3.55
1970	1,471	4,926	3.3	21,773	4.42
1972	1,496	5,141	3.4	28,293	5.50
1974	1,548	5,303	3.4	40,300	7.60
1976	1,614	5,580	3.5	56,029	10.04
1979	1,674	5,960	3.6	73,564	12.34
1982	1,721	6,369	3.7	93,971	14.75
1985	1,629	6,329	3.9	101,716	16.07

Source: Japan's Management and Coordination Agency, Japan Statistical Yearbook, 1986.

Small stores have been protected by the Large Retail Store Law, which requires cities and prefectures to take local interests into account when considering proposals to open large stores. The law, passed in 1974 and amended in 1979, restricts the opening of stores with a floor space exceeding 500 square meters (1,500 meters in the 11 largest cities). Applications to open stores of this size must be considered by prefectural governments and local city councils, which are often dominated by small retailers. While the council cannot ban a new store outright, it can make the application process excessively time-consuming and costly. In addition, it can impose conditions, such as limits on operating hours, that make the proposed store economically unattractive.

Table 7: Twenty Top Retailers in Japan, FY 1986

	Retailer	Sales (Y million)	Pretax Profits (Y million)	Number of Shops
1.	Daiei*	Y1,446,211	Y19,014	169
2.	Ito-Yokado*	987,804	52,074	127
3.	Seiyu*	823,512	9,458	172
4.	Jusco*	774,555	23,727	157
5.	Mitsukoshi	600,330	8,393	14
6.	Seibu	587,178	4,132	12
7.	Nichii*	560,370	18,154	158
8.	Takashimaya	525,020	13,358	6
9.	Daimaru	502,605	2,784	8
10.	Uny*	430,320	16,843	114
11.	Marui	400,727	35,300	34
12.	Matsuzakaya	372,896	8,575	9
13.	Kiosks	338,869	--	4,041
14.	Isetan	308,300	11,087	5
15.	Nagasakiya*	299,012	5,930	114
16.	Izumiya*	295,987	10,938	58
17.	Hankyu	285,893	6,403	8
18.	Tokyu	282,459	6,901	5
19.	Kotobukiya*	265,137	1,907	140
20.	Chujitsuya*	262,179	5,524	75

*Supermarkets. All other companies are department stores, except Kiosks.

Source: Japan Economic Journal, July 11, 1987.

Vertical Integration of Distribution Networks

The dominant role of wholesalers has been challenged in recent years by vertically integrated distribution systems established by large manufacturers to organize and control the channels of distribution. These are most powerful in industries where product differentiation is important, such as motor vehicles, consumer electronics, cosmetics, pharmaceuticals and cameras. Within the consumer electronics industry, for example, it is estimated that affiliated retailers account for 60 to 80 percent of the total sales of each manufacturer.

According to Hideto Ishida of the Japan Fair Trade Commission, vertically integrated distribution networks promote oligopoly power through:

- Exclusive dealership arrangements that prohibit retailers from selling the products of other manufacturers.
- Territorial restrictions that limit a retailer's sales to a specific geographic area.

- Limiting competition at the wholesale level by requiring retailers to purchase from designated wholesalers and restricting the sales of wholesalers to specified retailers.

- The organization of dealer associations by manufacturers to facilitate their ability to impose marketing plans on retailers.

These practices reduce competition by restricting the retailer's freedom to make independent business decisions.

There are several potential benefits associated with this type of distribution system. The close links between manufacturer and dealer are thought to improve customer service and provide producers with information on changes in consumer tastes. In addition, it reduces distribution costs by simplifying marketing channels. The savings, though, are unlikely to be passed on to consumers. The manufacturer's aim is to set the market price by preventing intra-brand price competition. The prices of differentiated products are likely to be higher, therefore, than under competitive conditions.

Impact on Imports

Although foreign governments and businesses have criticized Japan's distribution system as a nontariff barrier to trade, a 1985 Keidanren report concluded that "There is loud criticism of the Japanese distribution system, but studies have made it clear that, while much room remains for improvement, the system itself does not discriminate against foreign goods." The complexity of the system, however, makes finding an effective distribution channel a difficult problem for new entrants to the market, including imports. Moreover, the Japanese preference for stable, long-term relationships makes it difficult for new suppliers to win customers. A 1987 survey of major firms by the JFTC, for example, reported that 98 percent have been dealing with the same firm for more than five years. Imported goods may pose a risk since the retailer is uncertain whether the foreign producer accepts the Japanese custom of returning unsold merchandise.

In addition, the vertical integration of the distribution system is a formidable marketing weapon for some Japanese manufacturers and this creates barriers to new suppliers. Exclusive dealership requirements, for example, can prevent retailers from selling competing imported products.

Outlook

Japan's distribution system is in the midst of a major restructuring. The rising wealth and mobility of consumers is spurring the development of large retailers, whose sales per worker are much higher. With consumers demanding a larger variety of products than small stores can supply, the number of shops with less than five employees fell more than 100,000 between 1980 and 1985. The competitive pressures posed by the strong yen will also increase the emphasis on efficiency at the expense of traditional business practices.

Advances in technology will also help streamline the distribution system. Computer networks that transmit data across the many layers of the distribution system will help rationalize transport, storage, financing,

wholesaling and retailing. Examples of new technology that will benefit the distribution system include POS (point-of-sale) systems and value-added networks. Agreement on interchangeability and standardization is required to take full advantage of these data networks.

The 1986 Maekawa Report called on the government to review existing restrictions to promote the "streamlining of distribution mechanisms." One possible change would be the repeal of the Large Retail Store Law. The United States complained in 1985 that this was impeding the import of foreign products by restricting sales outlets. While the impact of the law may be overrated, its repeal should promote greater efficiency in the retail sector. Any change, though, is unlikely in the near future, given the political strength of small retailers.

The report also urged Tokyo to "ensure the strict enforcement of the antimonopoly law" in order to prevent unfair business practices. One possible target would be business practices that discourage competition by allowing manufacturers to control distribution channels. Practices such as exclusive dealerships, which are illegal in the United States, are still permitted in Japan.

And finally, the report says the government should ensure that "nothing is done to unfairly prevent parallel imports." Parallel importers buy brand name products abroad ranging from cars to watches and resell them in Japan at prices that are sometimes as much as 50 percent below the prices charged on goods imported through sole agents. Competitive pressure from parallel imports may help reduce the high markups on foreign goods sold by sole agents. The JFTC has already warned sole agents to stop harassing parallel importers by refusing to repair the goods they import or threatening to cut off supplies to stores that handle parallel imports.

A more efficient distribution system will benefit Japan's consumers by reducing prices and expanding selection. In addition, it should help foreign firms increase their market share in Japan and sustain the surge in manufactured imports. According to the Ministry of International Trade and Industry, the volume of manufactured imports jumped 24.6 percent in 1986, accounting for a record high 41.3 percent of total imports.

The benefits of a more efficient system, though, would be partially offset by a decline in employment in the distribution system. Japan's wholesale and retail industries are often described as an employment program financed by consumers through higher prices. Elderly persons often use lump-sum retirement benefits to open a small store that will provide a stream of income. In 1986 employment in the wholesale and retail industries (including food establishments) rose by 210,000, more than offsetting the loss of 90,000 manufacturing jobs. A reversal of this trend would boost Japan's unemployment rate, which rose to a record 3.2 percent in May.

For further information, contact Randall S. Jones.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.